IS THE CANADIAN DOLLAR DESTINED TO DISAPPEAR?
A CRITICAL PERSPECTIVE

by

Mario Seccareccia*
(University of Ottawa)

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The Politics and the Rhetoric of Monetary Integration

By a vote of 175 to 67, in March of 1999, Canada's House of Commons rejected a motion to study the creation of a North American monetary union and, thereby, eventually scrap the Canadian dollar. To my knowledge, this was the first time in almost 150 years since the adoption of the Canadian dollar in 1854 that such an idea had been entertained by the Canadian parliament (see Powell 1999). Although the motion had been introduced by the Bloc Québécois, a party that advocates Quebec's secession from the Canadian federation, the proposal had been supported primarily by conservative members of parliament. As expected, however, the governing Liberal Party together with the social-democratic New Democratic Party easily defeated the motion.

Not unlike the debate during the late 1980s over the Canada-U.S. Free Trade Agreement (FTA), a sharp cleavage has emerged politically in Canada. The traditional Left and Centre of the political spectrum is unanimously opposed to the notion of abandoning Canada's national currency. On the other hand, the political Right, the Tories and the Canadian Alliance, together with the Quebec sovereigntists (who tend broadly to be situated to the left of the Canadian political spectrum) have shown interest in forging stronger institutional links with the United States and entertaining the idea of a common currency. This is so despite the fact that the Bloc and the conservative members of Canada's parliament have widely different long-term political interests in supporting such policy of increased North American monetary integration. For instance, the Quebec indépendantistes view monetary union largely as a way of eliminating one more obstacle on the road towards political independence for Quebec; while the Canadian Right sees it as one additional opportunity to curtail the power of the state and further dismantle the Canadian welfare state.

During debate in the Canadian parliament, proponents of greater monetary integration did not, however, put forth such stark political concerns. The advocates of greater monetary integration with the United States shrewdly presented their view by articulating some of the arguments that are now quite familiar to economists well-versed in Mundellian economic logic. In particular, Mundell's prognostication of an
evolutionary trend towards some sort of tripolar world, with the emergence of a set of G-3 currency blocs based on the euro, the yen and the U.S. dollar (see Mundell 2000c), echoed in the halls of Canada's House of Commons. Given the underlying tendency in favour of international currency blocs, supporters of dollarization argued that government refusal to recognize this historical process towards monetary integration would place Canada in an unfavourable competitive position internationally and would impose severe costs on the Canadian economy. The political justification for this position to join a North American monetary bandwagon has, *inter alia*, been summarily stated in a paper by Courchene and Harris (1999: 3-4) in support of the establishment of a North American Monetary Union (NAMU):

"While a NAMU is not in the immediate horizon, there is nonetheless an urgent need to place the currency union issue on the public policy agenda. Policy developments within the NAFTA and elsewhere in the Americas appear to be moving quickly in the direction of dollarization. Since widespread dollarization could preclude the emergence of a NAMU by reducing the advantages the United States would garner from it and since,..., a NAMU would be preferable to dollarization from a Canadian perspective, Canada must become engaged on this issue with its NAFTA and hemispheric partners --- and sooner rather than later."

Greater monetary integration would supposedly bring forth significant benefits in the form of lower transaction costs, low inflation, higher output and greater economic stability. However, it is primarily the fear of being "left out" of a fast accelerating train of North American monetary integration that is being sold politically by those partial to the Mundellian logic.

It would appear that historically this bandwagon effect was also the principal political factor behind much of European monetary integration and that Mundellian analysis, based on the theory of optimum currency areas (OCA), was at best used only as a rhetorical device by the advocates of greater integration. For example, the establishment of the European Monetary System (EMS) --- a pegged exchange rate system tied to the German mark --- followed a bandwagon logic of development whereby fear of missing the European "train" pushed the recalcitrant Italian and British authorities ultimately to join the EMS. To quote Gruber (1999: 4),

"So what ... prompted the Italians (in 1979) and the British (in 1990) to relinquish their monetary autonomy? The answer, in a word is power --- specifically ... the "go-it-alone power" exercised by the EMS regime's French and German beneficiaries."

Hence, defying OCA logic, according to Gruber (1999), at least two of the EMS's largest signatories would have much preferred the pre-EMS system of floating exchange rates. Yet, fearing the political damages that non-entry entailed (see Dyson and Featherstone 1999, p. 474), the political authorities in Italy, and later in the United Kingdom, finally succumbed to the bandwagon pressures of greater monetary integration. They joined, therefore, even though this would entail, as was the case especially for Italy, lower economic performance than during the pre-EMS era. It is of interest to note that Mundell (1997: 215) himself has, in more recent times, defended the politics of being "left out" as the basis for the United Kingdom's eventual full-fledged entry into the euro fold in the near future.

Much like in Europe, and as history of monetary unions elsewhere broadly demonstrates (see Bordo and Jonung, 1999), it may be said that North America's monetary trajectory over the coming decade will not
be based on any underlying economic logic that ensues from the application of Mundellian theory of OCA but on the power politics that will ultimately be played out institutionally in the respective NAFTA countries. As Keynes once affirmed, political leaders may become persuaded by, and indeed become enslaved to, economic ideas of some academic scribbler of long ago but only if they serve as a rhetorical tool to further the leaders' specific political ends. This is not to deny the persuasive power of specific economic theories. In the struggle over public opinion, it is exactly the power of such ideas in shaping opinion, and therefore in remoulding the political *status quo*, that matters. However, as was the case with European monetary unification, it is not on the basis of OCA economic determinism that greater monetary integration will be sold to the Canadian public but primarily on the fears of being "left out" of some supposed accelerating NAMU train.

The politics and rhetoric notwithstanding, it has been precisely OCA deterministic logic that is generally espoused by those supportive of greater monetary integration in North America. Hence, the purpose of this paper is to analyze critically the basic arguments put forth in Canada by the defenders of Mundellian theory and to evaluate their relevance. To do this, I shall first seek to describe the shaky ground upon which this theory is based. This will then be followed by a broad critical analysis of the presumed economic benefits from greater monetary integration that OCA theory predicts.

**Mundellian Theory of Optimum Currency Areas: A Critical Analysis**

As pointed out by Goodhart (1998) and Parguez (2000), the dominant OCA paradigm is the lineal descendent of a long tradition in monetary theory on the nature and evolution of money that was perhaps best formulated by Karl Menger at the end of the nineteenth century. However, its historical origin is to be found in medieval times and is sometimes referred to as the *théorie marchandise* --- the commodity or metalist theory of money (see Seccareccia 1999). For this group of theorists, money should best be conceived as a specific commodity evolving from a barter system and which is eventually adopted via the spontaneous action of private agents seeking to minimize transactions costs. How, Menger (1892) asked, can a barter exchange system in which economic agents face the problem of the double coincidence of wants slowly evolve into a monetary economy? The solution which remains at the core of neoclassical monetary orthodoxy is that, in a given spacial and temporal transactions space, there will emerge a commodity whose objective characteristics in terms of degree of "saleableness (*Absatzfähigkeiten*)" (*i.e.* the degree to which economic agents are able to dispose of such a commodity to acquire other less "saleable" goods) are such as to be conferred the role of medium of exchange. Because of their intrinsic characteristics of fungibility, divisibility, durability and portability, Menger (1892) argued that this is why historically precious metals emerged as acceptable media of exchange both in local and in international markets without the intervention of the state. "Money", Menger (1892, pp. 255) wrote, "has not been generated by law. In its origin it is a social [*i.e.*, market], and not a state-institution. ... [state recognition and state regulation] have not first made money of the precious metals, but have only perfected them in their function as money." Moreover, given the monetary commodity's supply constraints, banks play no role in monetary creation since they are conceived only as intermediaries in their capacity to transfer a scarce monetary resource from savers to investors. Commercial bank deposits, and even central bank notes, appear, therefore, simply as "surrogates" for commodity money (Realfonzo 1998, chapter 2).

In opposition to this commodity view of money, there exists perhaps an even older approach. This latter tradition ties the existence of money to the role of the state both as the ultimate purveyor of liquidity and as the legal authority that bestows on a commodity its status as legal tender money within an institutional
structure defined by the state (see Innes, 1913). This approach has been dubbed the *théorie signe* or simply the Chartalist theory of money (Wray 1998, Mosler and Forstater 1999). Unlike Mengerian theory that considers money as the spontaneous outcome of a market process whose intrinsic characteristics ultimately qualify it as being money, Chartalist theory views money as a creature of the state and highlights the link between the existence and creation of money to the fiscal needs of the political authorities. The existence of a national currency (*i.e.* a token chosen by the state to command societal resources) is thus inseparable from the question of political sovereignty and from the state's prerogative to enforce tax payments within a precise geographical domain. In more advanced monetary economies in which has evolved a system of banking institutions that can create "inside" money *ex nihilo* (always denominated in the state's unit of account) via bank credit advances, both the legal existence of such institutions and the possible fulfilment of their liquidity needs (such as during times of crises) still would very much depend ultimately on the actions of the state (Parguez and Seccareccia 2000).

Mengerian analysis permeates much of neoclassical monetary theory, but its empirical applicability is, to say the least, very weak. Historically, there are many examples of how strong and stable monetary systems are often associated with strong and stable governments; while monetary debasement and flight from money have characterized a crumbling state authority. On the other hand, it would be difficult to find examples of currencies (even in their purest commodity forms) evolving "spontaneously" from barter without either the hidden or overt accompanying hand of the state. As argued by Goodhart (1998), despite Mengerian theory's lack of realism and its incapacity to explain the actual origin and general historical evolution of money, it is upon this latter conceptual *toile de fond* that Mundellian OCA theory has been grafted.

Mundellian OCA theory extends to international monetary relations similar Mengerian analytics to that pertaining to a national economic space. In particular, OCA theory rests primarily on the Mengerian concern with minimizing transactions costs. Since it is postulated that transactions costs rise exponentially with the number of currencies in circulation, money would slowly lose its traditional functions of unit of account and medium of exchange as the number of currencies increase within a given international economic space. Mundell (1961, p. 662) writes:

"Any given money qua numeraire or unit of account fulfils this function less adequately if the prices of foreign goods are expressed in terms of foreign currency and must then be translated into domestic currency prices. Similarly, money in its role of medium of exchange is less useful if there are many currencies; although the costs of currency conversion are always present, they loom exceptionally large under convertibility or flexible exchange rates. (Indeed, in a hypothetical world in which the number of currencies equaled the number of commodities, the usefulness of money in its role of unit of account and medium of exchange would disappear, and trade might just as well be conducted in terms of pure barter)."

On this basis, it would ensue tautologically that the optimum currency area would be the world as a whole with the existence of either a single world currency or a system of national currencies firmly locked together via fixed exchange rates, such as under the gold standard. However, as much as the prospect of a single world currency may be appealing to Mundell (2000a), because of asymmetric shocks to various regions internationally, regional differences in the structure of production, obstacles to factor mobility, and the extent of automatic stabilizers and/or interregional transfers, for OCA theorists such as Mundell (1961), McKinnon (1963) and Kenen (1969), an OCA cannot be the world but some subset of
Hence, as the theory of OCA has been filtered down historically and rendered empirically operational by economists such as Bayoumi and Eichengreen (1994, 1997), and, among many others, Williamson (2000), a list of important criteria have been proposed to determine whether any two regions or countries constitute an OCA and therefore should engage in greater bilateral integration via either a common currency or a pegged exchange rate. Some of the important conditions to be met can be summarized as follows: (i) the two regions or countries should be highly exposed as trading partners with foreign trade constituting a significant share of GDP; (ii) real shocks to output in both regions ought to be symmetrical, thereby giving rise to highly correlated business cycles; (iii) there should be present a high degree of factor mobility between the two regions, and (iv) there should be much institutional and policy convergence.

Empirical work in this area has shown that the theory of OCA can provide a wealth of meaningful information on the degree of economic symbiosis among countries, that is to say, on the extent to which economic integration is associated with monetary integration. However, as emphasized by Goodhart (1995), the predictive power of OCA criteria in explaining existing monetary integration internationally is terribly weak. Even where OCA theory has shown greater success, that is, in explaining why certain countries choose pegged exchange rate regimes to flexible exchange rate systems, the evidence is problematic for OCA theorists. For instance, in a study using the methodology developed by Bayoumi and Eichengreen (1997), Bénassy-Quéré and Lahrèche-Révil (1998) find that while some of the standard OCA criteria, such as the asymmetry of business cycles, can explain exchange-rate volatility and thus the degree to which countries should be anchored to the euro or the U.S. dollar, using their relative OCA index one would infer that currently countries such as Ireland, Spain, and the United Kingdom would benefit from pegging their respective currencies to the dollar rather than to the euro! Ironically, using a similar methodology, Bayoumi and Eichengreen (1997) found that France, together with the United Kingdom, Denmark, Finland and Norway, were a group of countries for which there was little evidence of exchange rate convergence vis-à-vis Germany, and thus concluded that "the desire for monetary unification in France is driven by political rather than economic considerations." (Bayoumi and Eichengreen, 1997, p. 769) From this, one may conclude that even explaining why economies such as France have bound themselves to fixed exchange rate systems has been a significant problem for OCA theorists.

If such conflicting evidence is not enough to question the usefulness of the OCA approach, paradoxically, where OCA theory is least effective is in the domain for which it was originally most intended, i.e. the field of common currencies. As pointed out by, among others, McKinnon (2000), in Mundell's (1961) original work, his theory sought to offer insights as to why optimal currency areas ought to be smaller rather than larger. Both in Mundell's original Canada-U.S. example and in most of the work patterned on OCA theory, such as that of Bayoumi and Eichengreen (1994), it would suggest that, when OCA criteria are applied to a common currency area such as the United States or Canada, the East and the West of the North American continent face supply disturbances that tend to be negatively correlated geographically. Hence, because of such strong regionally asymmetric shocks, ceteris paribus, OCA theory would recommend common currency areas that would more easily dissect the North American continent east-west rather than north-south, but would hardly advise in favour of a single North American currency! Hence, in large multi-regional blocs such as Canada, the United States, and even the current EMU, OCA theory would support that currencies be reorganized on a regional basis for overall welfare enhancement. The theory does not automatically predict, therefore, that a larger monetary
bloc is preferred to a smaller currency union. In fact, it is primarily for this reason that Mundell himself was very careful in his seminal article about the practical application of his theory. For instance, Mundell (1961, p. 661) concludes:

"In the real world, of course, currencies are mainly an expression of national sovereignty, so that actual currency reorganization would be feasible only if it were accompanied by profound political changes. The concept of an optimal currency area therefore has direct practical applicability only in areas where political organization is in a state of flux, such as in ex-colonial areas and in Western Europe."

In the final analysis, therefore, what really matters in explaining the actual history and existing structures of currency unions are broad political preferences and evolving political institutions and not ex ante economic rationalizing based on Mengerian transactions cost minimization. Hence, despite the high degree of economic integration between two regions, such as Canada and the United States, as Buiter (1999) has argued, without some form of political union to ensure an acceptable degree of accountability of a North American central bank, a NAMU would lack political legitimacy and would very quickly unravel.

While Mundell has been described as the chief architect or "father of the euro" (Salvatore 2000, p. 305) and has undeniably been one of its leading advocates, the irrelevance of OCA theory perhaps is most evident in explaining the creation of the European Economic and Monetary Union (EMU) itself. Despite the official rhetoric to the contrary, as pointed out by numerous advocates of the OCA approach, Mundellian theory cannot justify the formation of the EMU (see, among others, Feldstein 2000). Indeed, while depending on the precise empirical methodology, one can conceivably make a case for a "small EMU" centered around Germany, which could include some of the adjacent Benelux countries, one can hardly find any strong economic rationale for EMU's existence based on OCA theory. Even with the presence of common market arrangements spanning a few decades, many of the major EMU members are economically less integrated today than, say, Canada is with the United States (see Courchene 1998), and thus the case for welfare enhancement on the basis of OCA theory is not a very strong one. This, therefore, had brought supporters of the OCA approach, such as Eichengreen and Frieden (1994, p. 9), to conclude that "uncertainty about the empirical magnitude of every one of the [OCA calculated] benefits and costs suggests the absence of a clear economic case in favour of EMU." A similar blunt judgement on the EMU project is passed by Willett (2000, p. 383-84) when describing the actual process of European monetary unification:

"The leaders of the political push for EMU seemed totally unaware of the considerations emphasized by economists in the theory of optimum currency areas. They stressed [OCA] economic benefits as a sales technique, but it was clear that their basic objective was political, and discussion of EMU quickly took on all the signs of ideological debate. ... A particularly dangerous oversight of the European political elite was to ignore the warnings of the OCA theory that the sign of the net economic costs-benefits equation of monetary union can vary across countries. Some countries would have net benefits, others net costs. ... It may be welfare enhancing for a 'core' group of members, but clearly not for the full set of EU members."

Yet, when Mundell (2000b) and OCA proponents of North American monetary integration defend the prospects for a NAMU in this hemisphere, it is usually done on the basis of the success of the "euro
“revolution” exactly because of its Paretian welfare-improving implications in accordance with OCA theory (see Courchene 1998; Courchene and Harris, 1999; and Grubel 1999).

Even though OCA supporters do not fully agree on the precise significance of the EMU and on whether OCA is of limited usefulness to the understanding of actual currency areas, beginning with Mundell himself a number of economists partial to OCA theory have argued in favour of a NAMU for exactly the cornucopia of benefits that would result from its creation. In the following section, some of the specific arguments that have been put forth by these proponents of greater North American integration for either pegged exchange rates or the eventual elimination of the Canadian dollar (and the Mexican peso) will be discussed and critically evaluated.

The Benefits of Monetary Integration: Should Canada Become the 13th Federal Reserve District of a North American Monetary Union?

The launching of the euro in January 1999 may be considered a truly extraordinary event in monetary history. In fulfilling somewhat the Mengerian dream (see Parguez 2000), for the first time historically a group of eleven countries scrapped their national currencies and adopted a single currency. In the process, the EMU seemingly shattered the long-established link between money and the state by divorcing monetary policy (via an independent, supra-national and largely unaccountable ECB) from fiscal policy (to be pursued by national governments within the constraining framework of the Maastricht Treaty and the Amsterdam Stability and Growth Pact). Since the advent of the euro, there has been a proliferation of papers promoting the virtues of the EMU and its institutional adaptation to the North American continent.

In Canada, we are told by its most ardent supporters, such as Courchene (1998), Courchene and Harris (1999) and Grubel (1999), that Canada is no longer a viable OCA and that the economic benefits of greater monetary integration on the basis of the EMU blueprint are many and the costs are very few, the latter being usually associated with intangible political costs relating to the loss of national sovereignty. For instance, Courchene (1998, p. 20) concludes:

"... Canada is no longer an optimal currency area in terms of maintaining a stand-alone, freely-fluctuating currency. On grounds both of transactions certainty and accommodating asymmetric shocks and of pervasive forces triggering North American monetary integration, the optimal currency area for Canada involves the US currency area as well."

But what exactly are these presumed benefits of a NAMU?

(a) Efficiency Gains in the Form of Reduced Transactions Costs

The first of these benefits pertains to what traditionally has been the central proposition of OCA theory. This has to do with the existence of Mengerian static gains accruing to economic agents from minimizing transactions costs because of the elimination of currency transactions between two countries. Many of the studies in support of European monetary unification made much of these potential gains and the argument may be dubbed the "tourist" perspective on monetary union, as it was perhaps most dramatized by Emerson et al. (1992, p. 66) when calculating the currency transaction losses in a hypothetical round-trip through ten countries in Europe. If, with a common currency, one were to eliminate all the foreign exchange dealings between Canada and the United States, the economic gain would comprise the direct savings to the public engaged in cross-border transactions. These savings would represent essentially the loss of net financial revenues of banks and other foreign exchange dealers pertaining to
the elimination of the bid-ask spread of the pre-NAMU partner's foreign currency. Because of the net revenue loss, the savings to the public could be measured by the proportion that the foreign exchange departments of banks and other firms would shrink owing to the elimination of a large portion of the public's foreign exchange needs. For instance, Grubel (1999) provides a casual estimate for the NAMU countries as a whole at about 0.1 per cent of national income --- a figure which seemed perhaps more reasonable than the estimate of 0.4 per cent of GDP found in European studies following the Delors Report (Grubel 1999, p. 9).

Given the weight that reduced transactions cost holds in the OCA arsenal of arguments in favour of greater monetary integration, it is somewhat surprising that we are only talking about a 0.1 (or even a 0.4) per cent average annual efficiency gain from dollarization for Canada! While such welfare gain may not appear to be that substantial in size, in present value terms it would loom much larger. However, regardless of its estimated magnitude, such postulated gain is in fact highly illusive. Firstly, as pointed out by Arestis and Sawyer (1999) with respect to the euro, when these Mengerian welfare benefits are balanced against the costs of transition to a single currency, in present value terms the estimated net benefits tend largely to disappear. For instance, in referring to these estimated benefits, even in official reports such as that of Currie (1997, p. 6) it is stated quite candidly:

"The likely amounts [of the estimated benefits] are not however very large, and once the one-off costs of converting to the euro are taken into account as well, the net transactions savings do not provide a strong reason for moving to the euro."

Secondly, and perhaps even more importantly, when a new common currency is adopted (as was the case with the euro in January of 1999), naturally the effect would be to wipe out the bid-ask spread from which financial institutions can make a profit and, therefore, to reduce the direct cost for those engaged in such foreign exchange transactions. Yet, this ought not mean that these financial institutions would naively sit back to see their net revenues fall! Indeed, much of OCA theory is based on a view of the monetary system that largely abstracts from an analysis of the role of commercial banks. As profit maximizing institutions holding a certain degree of local monopoly, it would be much more realistic to assume that they would be attempting to maintain their overall bank revenues, for example, by charging service fees for related activities. This is basically what happened in Europe as of January 1999, when, in order to recoup some of their losses arising from the elimination of the foreign exchange spread, banks began opportunistically to charge user fees to citizens of the EMU countries seeking, for instance, to cash their travelers' cheques. It is most probably for this reason that the European Commission (1999, p. 3) kept warning the public after the launching of the euro that banks could not take advantage of the transition by charging the public for even the conversion of their national currencies into the euro!

Hence, the disappearance of one type of transaction costs seems merely to have triggered a compensating increase of alternative bank charges faced by the European public under a common currency arrangement. Unless one can show why the share of net revenues of financial institutions ought to fall under NAMU, the argument in favour of efficiency gains because of reduced transactions cost is terribly misleading. If the share of net bank revenues out of GDP would essentially remain unchanged between the pre- and post-NAMU period, this would result in a possible redistribution among economic agents of the burden of transacting within the enlarged currency space but not necessarily in a reduction of overall transactions cost to the community at large.

(b) Efficiency Gains in the Form of Higher Productivity
A second argument that has been promoted by those in favour of alternative currency arrangements for North America focuses, in this case, not on the presumed efficiency gains pertaining to lower transactions costs, but on the enhanced economic efficiency or increased productivity that would be forthcoming from greater monetary integration. Following the research findings of McCallum (1998a, 1999) who had looked at productivity growth in the Canadian manufacturing sector since 1977, there was found to be a strong statistical correlation between the Canada/U.S. exchange rate (lagged two years) and manufacturing productivity growth. From these findings, which have been further reinforced by anecdotal evidence in the Canadian media about the "lazy" manufacturing sector being favoured by the declining exchange rate, advocates of greater monetary integration with the United States have suggested that there is a causal link between the falling Canadian dollar and low productivity growth.

The idea is quite simple and it is based on the premise that a floating Canadian dollar since the 1970s has had a long-term negative effect on Canada's competitiveness. While there is a short-term gain associated with a floating exchange rate in amortizing external shocks to the Canadian economy, the long-term impact of a falling dollar on productivity growth in the export sector would supposedly be negative. The argument is appealing and has been marketed a great deal by advocates of pegged exchange rates and greater monetary integration, such as Courchene (1998) and Courchene and Harris (1999). As Laidler (1999a, p. 8) notes, however, the evidence is highly circumstantial.

As is displayed in Chart 1, it is true that when the Canadian dollar was pegged to the U.S dollar between 1962 and 1970 (and even during the 1950s and the early 1970s under a floating regime --- an era in which the Canadian dollar generally showed much greater stability), this was indeed associated with a period of somewhat higher productivity growth both for the manufacturing sector and for the business sector as a whole. However, as Table 1 shows, when looking at output per person employed since 1960, Canada showed a mild decline comparable to that of the U.S. and the U.K. between the 1960-79 period and the 1980-98 period --- thus questioning the significance of the depreciating Canadian dollar in impacting on overall productivity growth. In fact, further econometric work undertaken by Dupuis and Tessier (2000) at the Bank of Canada found that McCallum's (1998, 1999) original bivariate system was highly problematic because of specification error and that a more comprehensive multi-variate analysis found that manufacturing productivity growth and the Canada-U.S. exchange rate to be statistically unrelated variables.

| TABLE 1: Real GDP per Capita and Per Employed Person |
| (Average Annual Percentage Change, 1960-1998) |

| Percentage Decline |

| Real Gross Domestic Product per Capita |
| Canada  3.1 1.6 48.4 |
| Japan  6.1 2.6 57.4 |
Perhaps, of further annoyance to those supportive of the "lazy manufacturer" hypothesis: if exchange rate fixity is of such crucial importance to productivity growth, why is it that the European countries who joined the EMS and subsequently the EMU during the post-1979 period faced an even sharper drop in productivity growth? Indeed, (as shown in Table 1) even such small open economies as Austria and Belgium which are probably in a similar relation vis-à-vis the core countries of the EMU (France and Germany) as Canada is with the U.S., their growth rates of labour productivity (as measured by real GDP per employed person) and growth in their standards of living (as measured by real GDP per capita) all plummeted during the post-1979 period, even though, unlike Canada, they had been pegging their exchange rates within the EMS throughout this period. Stability in the exchange rate did not seem to provide much protection against an even sharper drop in productivity growth for all those European countries that joined the EMS since 1979! In much the same way, one could legitimately argue that greater monetary integration, in the form of pegged exchange rate or dollarization, with the other NAFTA partners could hardly be expected to be a significant factor in speeding up productivity growth in Canada.
(c) Gains in the Form of Lower Real Interest Rates

A third argument in the Mundellian defence of greater monetary integration has to do with the dampening effect that monetary unification would have on the level of interest rates in Canada. Once again the hypothesis put forth is a very simple one. While sovereign or default risk has never been a visible concern for foreign holders of Canadian securities, exchange rate risk ought to be a very real concern, especially for long-term bond holders because of the risk of exchange rate depreciation. It would ensue, therefore, that, because of the weight of risk-averse bond-holders, the greater the volatility in the exchange rate, the higher ought to be the real interest rate spread between Canada and the U.S. Moreover, as it has been argued by many EMU observers, since greater monetary integration leads to the further deepening of financial markets (see, *inter alia*, Eichengreen 2000), this would probably have a further desirable negative impact on domestic interest rates in both countries. Consequently, if these factors are at all important in the determination of interest rates, one ought to find a significant long-term association between exchange rate stability/volatility and the real interest rate spread on long-term bonds across countries.

Chart 2 presents data on both the nominal and real interest rate spread on long-term government bonds (10 years and over) between Canada and the U.S. Casual observation surely would not lead one to conclude any significant decline for the 1962-1970 period during which Canada had pegged its currency to the U.S. dollar. Indeed, while both the nominal and real interest rate spread remained relatively stable during the first half of the 1960s, by the latter half of the decade there was a significant upward movement. Moreover, evidence from our charts does not suggest that greater exchange rate stability is necessarily associated with lower spreads. As can be inferred from Chart 1, even during the decades when Canada had floated its exchange rate (as during the 1950s and 1970s), the Canada-U.S. exchange rate showed a high degree of stability (when compared with the decades of the 1980s and 1990s). For instance, when measuring the variability in terms of standard deviation, data in Chart 1 exhibit a standard deviation for the 1980-2001 period over twelve times that for the period from 1950-1979. Did this greater volatility lead to a steep rise in the real interest spread between Canada and the United States for the post-1980 period? The data from Chart 2 shows no such sharp increase on average. For instance, the mean value in the real interest rate spread for the period 1950-1979 went from 0.93 percentage point spread to 1.01 percentage point for the 1980-2001 period. While this was not an insignificant increase, it would be difficult to attribute most of this rise to the greater volatility in the exchange rate rather than to the relatively more restrictive monetary policy stance of the Bank of Canada during the 1980s and first half of the 1990s in fighting inflation (see Seccareccia 1998). Indeed, empirical evidence in a related study explaining long-term interest rates in Canada (see Seccareccia and Lavoie 2001) found that movements in the central bank-controlled variables, such as the overnight rate, were of crucial importance in explaining the movement of long-term interest rates, thereby emphasizing the difference in the respective monetary policy positions in explaining the slight widening of the Canada-U.S. interest rate differential since 1980.

A similar argument can be made with respect to the European experience with monetary integration. With the breakdown of the Bretton Woods system during the early 1970s, European countries did attempt under follow-up agreements to the Werner Report of 1970 to establish a structure of exchange rates, often referred to as the European "snake", but which led to extremely loose and fluid relations during the 1970s until the creation of the EMS in 1979 (see Apel 1998, chapter 1). Hence, the 1970s was a period during which some of the major players of what ultimately has become the EMU, such as Italy and even France, experimented with much greater flexibility in their exchange rate system, especially
subsequent to the first oil price shock in 1973. Theory would thus suggest that elimination of some of the exchange rate volatility would have led to lower interest rates in Europe with respect to some benchmark interest rate. To evaluate whether this led to a widening of interest rate spreads, a comparison was done by looking at the difference between, on the one hand, the average real rates of the original core countries of the Exchange Rate Mechanism (ERM) of the EMS (France, Italy, the Federal Republic of Germany, and the Benelux countries) and the benchmark U.S. real rates on the other. The data displayed in Chart 3 was based on a simple averaging of the real rates of the five core countries (with the exclusion of Luxembourg) for the period between 1965 and 1999. While undoubtedly many factors would have impacted on the interest rate spread, it would be difficult to conclude from the chart that greater monetary integration in Europe led to a narrowing of the interest rate spread vis-à-vis the United States. For instance, the chart shows that the spread fell significantly during a good portion of the 1970s, only to rise during the late seventies and then fall sharply and rise again from the early 1980s to mid-1990s. Interestingly, when comparing the evolution for the European countries (in Chart 3) to the Canada-U.S. real interest rate spread (previously in Chart 2), a close analysis would confirm that their pattern is conspicuously similar (even though these countries were under very different exchange rate regimes).

Once again, one can infer from this that, at least from simple graphical analysis, evidence to support the views of Grubel (1999) and others as to the beneficial effects of eliminating nominal exchange rate variability on long-term interest rates is extremely weak if non-existent. This is not to argue that exchange risk is of little importance to long-term bond holders. Rather, as also emphasized by Seccareccia and Lavoie (2001), market forces are perhaps less important than the policy actions of the monetary authorities in determining the level of both short and long-term interest rates and, thus, the interest rate spread between Canada and the U.S.

In an ironic twist, in recent times, some have argued (see Bell 2000 and Mosler 2001) that, if anything, the current structure of the EMU which is so idealized by the Mengerians because of the clear separation of money from the state, may have probably created problems of default risk for the member countries of the EMU. This is because of the lack of liquidity provisions in the Maastricht Treaty which currently prohibits national governments to borrow from the European Central Bank even in times of financial crisis. Therefore, unlike the customary view that default risk and exchange rate risk are complementary (see Rojas-Suarez 2000), some have argued that, while exchange rate risk would de facto be eliminated under monetary union, the peculiar type of supra-national monetary arrangement along the lines of those existing in Euroland presently may have created more serious problems of default risk if, for instance, a banking crisis were to erupt in any one of the EMU member countries.

(d) Miscellanea

In addition to these three important arguments in favour of greater North American monetary integration discussed above, there exists a plethora of other arguments that have traditionally been called upon to support greater monetary integration in North America. Among the other arguments that proponents such as Grubel (1999) have identified traditionally, there is at least one that merits mention here because of its important theoretical ramifications. We are told that greater monetary integration in the form of pegged exchange rate or outright monetary union will impose the needed discipline on the fiscal authority as exemplified by the current experience of the EMU (see Courchene 1998, p. 18; and Grubel 1999, p. 15). While the theoretical underpinnings of this point of view are quite fluid and founded on questionable economic logic (to be discussed below), where is the evidence that a floating exchange rate leads to fiscal "indiscipline"? To paraphrase McCallum (2000, p. 8), how can we explain the fact that, despite its
floating currency, over a good number of years during the 1990s Canada has been running primary surpluses and is essentially meeting all of the Maastricht criteria? Moreover, as displayed in Chart 4 for the period between 1978 and 2000, the evolution of primary balances (as a percentage of GDP) under fixed exchange rates in Europe has not been very different than that under a flexible exchange rate regime in Canada. Unlike Europe, this was achieved in Canada without a major constitutional change to enforce quasi-balanced budgets.

Why then all this concern with fiscal discipline? The reason has to do with the Mundellian underpinnings of the theory of monetary union. In a world of high capital mobility, Mundellian theory as developed during the early 1960s identified fiscal policy as a powerful instrument of macroeconomic stabilization and, therefore, provided at the time strong theoretical support for those favouring activist fiscal intervention. However, under monetary union, such as would be the case under the proposed NAMU, an expansionary fiscal policy, say, to combat unemployment in Canada is widely postulated to have negative externalities on its NAMU partner, the United States (see Carlberg, 1999). This is because, while a fiscal expansion in Canada would raise Canadian domestic income through the usual multiplier effect, the upward pressure that the expansionary fiscal action would place on overall NAMU interest rates would lead to an appreciation of the NAMU dollar and thus to a fall in net exports in both countries. The final outcome of the Canadian fiscal expansion is assumed to be a relative rise in Canadian income that would largely be done at the expense of a fall in U.S. income. However, the overall effect on the monetary union would be negative, since it would be associated with higher interest rates (with its usual investment crowding-out implications) in both countries, a higher common currency exchange rate and lower net exports of each member country vis-à-vis the rest of the world. Given this perceived problem of moral hazard pertaining to the behaviour of any member country of a monetary union, strict constitutional rules must be put in place to guarantee fiscal discipline, such as those that have been imposed on the member states of the EMU.

Unfortunately for the member states of the EMU, the imposition of strict rules of fiscal austerity (in accordance with the criteria of the Stability and Growth Pact) has been premised on a highly questionable Mengerian (or neoclassical) theory of money that sees higher interest rates as the unavoidable consequence of a fiscal expansion. If, instead of this questionable neoclassical theoretical framework with its explicit assumption of exogenous money, one were to frame the analysis within the competing Post-Keynesian theory of endogenous money (see Lavoie 1992; and Rochon 1999), these negative consequences of an activist fiscal policy cannot be inferred (see Seccareccia and Sharpe 1994; and Seccareccia and Sood 2000). On the contrary, within this latter analytical framework, fiscal policy would be a necessary tool to achieve greater economic welfare. As argued by Arestis, McCauley and Sawyer (2001), the arbitrary 3-percent-of-GDP limit on budget deficits seriously impairs the EMU members' ability to absorb macroeconomic shocks and condemns them to rely on the limited monetary policy actions of a highly undemocratic and unrepresentative ECB whose sole responsibility is price stability. Why would the member states of the EMU want to abandon such an important instrument of macroeconomic policy on the basis of a questionable theory of money and to accept as consequence higher long-term rates of unemployment? If the structure of the EMU will lead to increasing problems of unemployment, as predicted, for instance, by Feldstein (1997), how long would national governments last in imposing fiscal austerity domestically? Recently, even some of the strongest supporters of the EMU system (see Fitoussi 2000, p. 20) are beginning to question the current policy mix of the EMU that (a) has given prominence to orthodox monetary policy in favour of price stability, (b) has led to the complete abandonment of fiscal policy as a macroeconomic tool, and (c) has imparted a deflationary bias
Concluding Remarks

To reply to the question as to whether the Canadian dollar is destined to disappear, it can be said that OCA theory does not offer much of an answer based on its economic/deterministic logic. There are clear political forces at work in Canada, moving in the direction of greater monetary integration with the United States, who have employed Mundellian theory to further their specific political ends. However, as was shown, their arguments have been based on OCA theory that rests on terribly shaky foundations. In addition, the presumed benefits that would accrue to those countries moving in the direction of greater monetary integration are themselves highly uncertain. In particular, we have seen how some of the postulated benefits, in terms of lower transaction costs, increased productivity, lower real interest rates, and increased fiscal discipline are based neither on theoretically sound logic nor can they call upon strong empirical support. While the economic arguments are weak, one can never underestimate their capacity to be absorbed by political leaders. Since public opinion is very much conditioned by cataclysmic events, it would probably only take a strong external shock leading to a very sharp drop in the value of the Canadian dollar to move Canadian political opinion inexorably in the direction of greater monetary integration with the United States. Once confidence in a currency is lost, it will be difficult to stop the bandwagon phenomenon from building strength and, so long as it reinforces popular belief, politicians will espouse any argument regardless of its theoretical worth and empirical validity. Hence, depending on the political dynamics, just as in Europe, it is certainly conceivable that the Canadian dollar might disappear. However, as the European experience teaches us, other than for their rhetorical value, it is highly unlikely that OCA arguments based on Mundellian economic/deterministic logic will have any significance in determining such a future outcome.

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